

Office of Chief Counsel  
Internal Revenue Service

**memorandum**

CC:LM:NR: [REDACTED]: POSTF-103018-02  
[REDACTED]

date: April 30, 2002

to: LMSB Examination  
Team Manager, Group [REDACTED]

from: Area Counsel  
(Natural Resources: [REDACTED])

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subject: Request for LMSB Division Counsel Assistance - Statute of  
Limitations

[REDACTED] Corporation and Subsidiaries

EIN: [REDACTED]  
[REDACTED] (FSC)

Last Known Address: [REDACTED]

Street Address: [REDACTED]

This memorandum supersedes our advice to you dated March 7, 2002 based upon modifications proposed by the National Office. The majority of the advice remains unchanged. We have, however, dropped all discussion of equitable recoupment since the statutory mitigation provisions preempt common law recoupment remedies with respect to the circumstances enumerated in I.R.C. §1312. In order for you to more easily see the changes we made, we have highlighted the additions to our original memorandum. This memorandum should not be cited as precedent.

DISCLOSURE STATEMENT

This writing may contain privileged information. Any unauthorized disclosure of this writing may have an adverse affect on privileges, such as the attorney-client privilege. If disclosure becomes necessary, please contact this office for our views.

ISSUES

1. What is the statute of limitations for assessment of tax shown on amended Forms 1120 FSC for the [REDACTED] and [REDACTED] tax years? UIL No.: 6501.00-00

2. If the statute of limitations has expired for assessment, whether the Service may offset the barred deficiency shown on the amended returns of the taxpayer's foreign sales corporation against the overpayment shown on the amended returns of the taxpayer who wholly owns the foreign sales corporation? **UIL No.: 58.00.00-00**

3. Whether the Service may mitigate its error under I.R.C. §§ 1311 through 1314? **UIL Nos.: 1311.00-00; 1313.03-00**

#### CONCLUSIONS

1. The statute of limitations for assessment of tax on the [REDACTED] and [REDACTED] amended Forms 1120 FSC expired on [REDACTED] and [REDACTED], respectively.

2. **No, the Service may not offset the barred deficiency because setoff only applies where the setoff involves the same type of tax for the same year by the same taxpayer and, in this case, two different taxpayers are involved.**

3. No, the mitigation provisions of I.R.C. §§ 1311-14 do not apply because the taxpayer's foreign sales corporation cannot be a member of the same **affiliated** group as the taxpayer and therefore cannot be a "related taxpayer" within the meaning of I.R.C. § 1313(c)(7).

#### FACTS

I have relied on the facts set out in this memorandum for my opinion in this case. If you believe that I should consider additional facts, you should notify me as this could change my opinion.

The taxpayer is a domestic 1120 corporation that is the sole owner of a foreign sales corporation. The taxpayer timely filed, with valid extensions, both the original 1120 and 1120 FSC tax returns for the [REDACTED] and [REDACTED] tax years on [REDACTED] and [REDACTED], respectively.

The taxpayer was a designated [REDACTED] case for the [REDACTED] and [REDACTED] tax years. In late [REDACTED] the taxpayer moved its corporate headquarters from the [REDACTED] District to the [REDACTED] District. The tax returns were then assigned to the [REDACTED] LMSB Division. In early [REDACTED] the [REDACTED] LMSB Division decided to survey the tax returns for the [REDACTED], [REDACTED], and [REDACTED].

tax years and to begin the audit with subsequent tax years. The Service contacted the taxpayer and informed it of this decision. Based upon the Service's decision to survey the [REDACTED] through [REDACTED] cycle, the taxpayer agreed to amend its [REDACTED], [REDACTED], and [REDACTED] 1120 tax returns to reflect the following:

1. The carry-forward audit adjustments from prior Service examinations.
2. Additional changes resulting from income and expense items that had been omitted on the original filing of the tax returns but not discovered until after the filing of the [REDACTED] through [REDACTED] tax returns.
3. Additional changes resulting from changes in the reporting of foreign transactions from the grouping-of-sales method to a transaction-by-transaction method.

**As a result of taxpayer's redeterminations to change from a grouping method to a transaction-by-transaction method, the commissions (i.e., gross income, see Temp. Treas. Reg. §1.927(b)-1T(e)(1)) paid to the FSC increased, and the corresponding commission expense deductions available to the related supplier increased in the same amount. As such, the taxpayer agreed to amend the 1120 FSC returns for the [REDACTED], [REDACTED], and [REDACTED] tax years to reflect this increase in taxable income brought about by the change in method for reporting foreign transactions.**

On [REDACTED], the [REDACTED] LMSB Division office received Forms 1120X and amended Forms 1120 FSC for the [REDACTED], [REDACTED], and [REDACTED] tax years from the taxpayer. The taxpayer also submitted requests for offset of the amended Forms 1120 FSC liabilities by the overassessments due from the Forms 1120X for each year. The [REDACTED] LMSB Division forwarded the Forms 1120X to the [REDACTED] Service Center and the amended Forms 1120 FSC to the [REDACTED] Service Center. The [REDACTED] LMSB Division attached specific instructions to the amended returns requesting that the Service Centers not make any deficiency assessments on the amended 1120 FSC returns nor pay any refunds on the 1120X returns. The Service Centers followed the instructions of the LMSB Division.

As a result of the changes agreed to by the taxpayer, the Forms 1120X filed for the [REDACTED] through [REDACTED] tax years showed additional refunds totaling \$ [REDACTED]. The amended Forms 1120 FSC filed for the [REDACTED] through [REDACTED] tax years showed increased liabilities totaling \$ [REDACTED] comprised of liabilities in the amount of \$ [REDACTED] for [REDACTED], \$ [REDACTED] for [REDACTED], and \$ [REDACTED] for [REDACTED].

#### LEGAL DISCUSSION

##### Statutes of Limitations for FSC Grouping Redeterminations

Temp. Treas. Reg. § 1.925(a)-1(c)(8)(i) provides that the requirements of Temp. Treas. Reg. § 1.925(a)-1T(e)(4) apply to grouping redeterminations. Temp. Treas. Reg. § 1.925(a)-1T(e)(4) provides:

The FSC and its related supplier would ordinarily determine under section 925 and this section the transfer price or rental payment payable by the FSC or the commission payable to the FSC for a transaction before the FSC files its return for the taxable year of the transaction. After the FSC has filed its return, a redetermination of those amounts by the Commissioner may only be made if specifically permitted by a Code provision or regulations under the Code. Such a redetermination would include a redetermination by reason of an adjustment under section 482 and the regulations under that section or section 861 and § 1.861-8 which affects the amounts which entered into the determination. In addition, a redetermination may be made by the FSC and related supplier if their taxable years are still open under the statute of limitations for making claims for refund under section 6511 if they determine that a different transfer pricing method or grouping of transactions may be more beneficial. Also, the FSC and related supplier may redetermine the amount of foreign trading gross receipts and the amount of the costs and expenses that are used to determine the FSC's and related supplier's profits under the transfer pricing methods. Any redetermination shall affect both the FSC and the related supplier. The FSC and the related supplier may not redetermine that the FSC was operating as a commission FSC rather than a buy-sell FSC, and vice

versa.

This rule requires not only that the statute of limitations for assessment under section 6501 be open but also that, as a condition precedent to a taxpayer-initiated grouping redetermination, that the period of limitations for refund under section 6511 must be open with respect to both the FSC and the related supplier. See Union Carbide Foreign Sales Corp. v. Commissioner, 115 T.C. 423 (2000) (with respect to the latter requirement). Thus, Temp. Treas. Reg. § 1.925(a)-1T(e)(4) provides that if the statute of limitations bars assessment of the FSC, the grouping redetermination that would otherwise give rise to such assessment is barred because the redetermination would not "affect both the FSC and the related supplier." In this case, the statute of limitations did not bar assessment of the FSC when the Service received the taxpayer's 1120X and amended 1120 FSC returns for the [REDACTED], [REDACTED], and [REDACTED] taxable years.

#### Statute of Limitations on Assessment

I.R.C. § 6501(a) contains the general rule that the Service must assess tax due within three years of the date of filing of the return regardless of whether or not such return was filed on or after the date prescribed.

I.R.C. § 6501(c)(4) permits taxpayers and the Service to enter into an agreement to extend the period of limitation for assessment of tax, provided that the agreement is executed prior to expiration of the period of limitation for assessment which is otherwise applicable.

In the absence of an agreement extending the period for the assessment and collection of tax, an assessment of tax must be made within three years from the later of the due date of the return or the date filed. I.R.C. § 6501. A claim for refund must be made before the later of three years from the date the return was filed or two years from the date the tax was paid. Any assessment of tax or claim for refund commenced after the statute of limitations has expired is invalid.

Section 6501(c)(7) provides an exception to this general limitation on assessments for certain amended returns:

Where, within the 60-day period ending on the day on which the . . . [period of limitation on assessment]

would otherwise expire, the Secretary receives a written document signed by the taxpayer showing that the taxpayer owes an additional amount of . . . [tax], the period for the assessment of such additional amount shall not expire before the day 60 days after the day on which the Secretary receives such document.

An amended return on which tax-increasing adjustments were offset by tax-decreasing adjustments would not show "an additional amount of tax" and would not trigger the extension under I.R.C. § 6501(c)(7).

I.R.C. § 6501(e)(1)(A) provides that, if the taxpayer makes an omission of more than 25% from gross income, the Service may assess tax within six years of the date of filing of the original return. Section 6501(e)(1)(A)(i) defines "gross income" in the case of a trade or business as "the total of the amounts received or accrued from the sale of goods and services (if such amounts are required to be shown on the return) prior to diminution by the cost of such sales or services." **In the case of a commission FSC, the concept of "gross income stated in the return" corresponds to gross receipts on the sale, lease or rental of property upon which commissions arose, plus any other income of the FSC. See I.R.C. § 927(b)(2); Temp. Treas. Reg. § 1.927(b)-1T(e)(1).**

Given the facts in this case, **I.R.C. § 6501(e)(1)(A) is inapplicable and** the statute of limitations on assessment for the [REDACTED] tax year expired on [REDACTED]--three years from the date of filing plus an additional sixty days due to the fact that the amended return was filed on the last day for making the assessment. For the [REDACTED] tax year, the statute of limitations on assessment expired on [REDACTED].

#### Offset of Barred Deficiency

The doctrine of setoff can apply only where a barred deficiency (or overpayment, as the case may be) exists for the year at issue. See Stone v. White, 301 U.S. 532, 538 (1937); Lewis v. Reynolds, 284 U.S. 281, 283 (1932); Americold Corp. v. United States, 28 Fed. Cl. 747, 755 (1993). The statute of limitations on assessment, section 6501, otherwise proscribes reduction of a timely claim for refund by a barred deficiency, provided the doctrines of equitable recoupment and estoppel do not apply. Stone, 301 U.S. at 538-39.

The doctrine of setoff is traceable to Lewis v. Reynolds, 284 U.S. 281 (1932). In Lewis, the administrator of an estate filed a return claiming certain deductions. The Commissioner disallowed all but one of the claimed deductions and assessed a deficiency, which the estate paid. Thereafter, the administrator filed a claim for refund. The Service rejected the claim on the ground that additional tax was owed. The additional tax, although barred from assessment by the statute of limitations, was arrived at by disallowing the previously allowed deduction, and by allowing the previously disallowed deduction. In concluding that the Service's action was proper, the Court stated:

While the statutes authorizing refunds do not specifically empower the Commissioner to reaudit a return whenever repayment is claimed, authority therefor is necessarily implied. An overpayment must appear before refund is authorized. Although the statute of limitations may have barred the assessment and collection of any additional sum, it does not obliterate the right of the United States to retain payments already received when they do not exceed the amount which might have been properly assessed and demanded.

Id. at 283.

In Dysart v. United States, 340 F.2d 624 (Cl. Ct. 1965), the court focused on the principles set forth in Lewis and determined that the government had a right to assert setoff where the setoff involved the same type of tax for the same year by the same taxpayer. Id. at 628. In this case, the doctrine of setoff does not apply because two different taxpayers are involved--setoff applies where the setoff involves the same type of tax for the same year by the same taxpayer.

#### Mitigation

The mitigation provisions of I.R.C. §§ 1311-14 authorize the correction of errors that are otherwise prevented by operation of law. I.R.C. § 1311 authorizes adjustments of the tax for a closed year if all of the following conditions exist. First, there must exist a "determination" as defined in I.R.C. § 1313. Second, there must have been an error in the way an item was handled in a barred year, which falls

within one of the categories set forth in I.R.C. § 1312. Third, correction of the error is prevented by some rule of law. Finally, except in situations described in I.R.C. § 1312(3), the position adopted in the "determination" must have been inconsistent with the erroneous treatment and the inconsistent position must have been asserted by the party against whom the adjustment is sought. The purpose of these provisions is to prevent a windfall to the Service or to the taxpayer arising out of the treatment of an item in a manner inconsistent with its erroneous treatment in a closed year. See Bolten v. Commissioner, 95 T.C. 397, 402 (1990). These provisions may ameliorate the impact of the statute of limitations under certain circumstances.

I.R.C. § 1312 enumerates the circumstances under which an adjustment may be made for a closed year. I.R.C. § 1312(3)(A) provides for an adjustment if the determination requires the exclusion, from a taxpayer's gross income, of an item excluded in a return filed by the taxpayer, or with respect to which tax was paid, and which was erroneously excluded or omitted from the gross income of a related taxpayer for the same or another taxable year. See Treas. Reg. § 1.1312-3(a)(1). I.R.C. § 1312(6) provides for an adjustment if the determination allows or disallows a deduction in computing the taxable income of a corporation, and a correlative deduction or credit has been erroneously allowed, omitted, or disallowed, as the case may be, in respect of a related taxpayer described in section 1313(c)(7).

I.R.C. § 1313(c) provides, in pertinent part:

that the term "related taxpayer" means a taxpayer who, with the taxpayer with respect to whom a determination is made, stood, in the taxable year with respect to which the erroneous inclusion, exclusion, omission, allowance, or disallowance was made, in one of the following relationships:

. . . .

(7) member of an affiliated group of corporations (as defined in section 1504).

In this case, the taxpayer's FSC is a foreign corporation. As such, the taxpayer's FSC is not a member of the same **affiliated** group as the taxpayer. I.R.C. § 1504(b)(3) (excluding foreign corporations from the definition

of "includible corporation"). I.R.C. § 1313(c)(7) provides that the term "related taxpayer" means a member of an affiliated group of corporations as defined under I.R.C. § 1504. **See also I.R.C. §7701(a)(5) (defining a foreign corporation)**. Since the taxpayer's FSC does not meet this definition and the adjustment pertinent to the case at hand may only be made for a "related taxpayer," the mitigation provisions do not apply in this case.

If you have any questions on this matter, please call me at [REDACTED].

[REDACTED]  
Associate Area Counsel (LMSB)

By: \_\_\_\_\_  
[REDACTED]  
Attorney (LMSB)

cc: [REDACTED] Revenue Agent, LMSB Group [REDACTED]